



2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Administrator, Federal Aviation Administration
Inspector General, U.S. Department of Transportation:

We have audited the accompanying balance sheets of the Federal Aviation Administration (FAA) as of September 30, 2004 and 2003, and the related statements of net cost, changes in net position, budgetary resources, and financing for the years then ended (herein referred to as "financial statements"). The objective of our audits was to express an opinion on the fair presentation of these financial statements.

In connection with our audits, we also considered the FAA's internal control over financial reporting and tested the FAA's compliance with certain provisions of applicable laws, regulations, contracts and grant agreements that could have a direct and material effect on its financial statements.

SUMMARY

As stated in our opinion on the financial statements, we concluded that the FAA's financial statements as of and for the years ended September 30, 2004 and 2003, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 16 to the financial statements, the FAA restated its fiscal year 2003 budget authority and unobligated balance reported on the Combined Statement of Budgetary Resources.

Our consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

1. Implementation of a New Financial Accounting System
2. Cost Accounting Information
3. Reconciliations of Fund Balance with Treasury
4. Information Technology Controls over FAA and Third-Party Systems and Applications
5. Cost Reimbursable Contracts

However, these reportable conditions are not believed to be material weaknesses.

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The results of our tests of FFMIA disclosed deficiencies in financial management information systems, the application of federal accounting standards, and recording of financial transactions that are presented within the Exhibits of this report.



The following sections discuss our opinion on the FAA's financial statements, our consideration of the FAA's internal control over financial reporting, our tests of the FAA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements, and management's and our responsibilities.

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of the FAA as of September 30, 2004 and 2003, and the related statements of net cost, changes in net position, budgetary resources, and financing for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the FAA as of September 30, 2004 and 2003, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 16, the FAA restated its fiscal year 2003 budget authority and unobligated balance reported on the Combined Statement of Budgetary Resources.

As discussed in Note 1, *Summary of Significant Accounting Policies*, and Note 13, *Airport and Airway Trust Fund Dedicated Collections*, the accompanying financial statements reflect actual excise tax revenues deposited in the Airport and Airway Trust Fund through March 31, 2004, and excise tax receipts estimated by the Department of Treasury's Office of Tax Analysis for the two quarters ended June 30, 2004 and September 30, 2004.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The information in Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the FAA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2004 audit, we noted certain matters, described in Exhibit 1, involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that none of the reportable conditions presented in Exhibit 1 are material weaknesses.

A summary of the status of prior year reportable conditions is included as Exhibit 3.



We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of the FAA in a separate letter.

COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02.

The results of our tests of FFMIA disclosed instances, as discussed in Exhibit 2, where the FAA's financial management systems did not substantially comply with Federal financial management systems requirements, which call for a single, integrated financial system. The FAA has not fully integrated managerial cost accounting standards and was unable during fiscal year 2004 to provide timely and complete cost information to its managers.

We also noted other matters involving compliance that, under *Government Auditing Standards* and OMB Bulletin No. 01-02, were not required to be included in this report, that we will report to the management of FAA in a separate letter.

RESPONSIBILITIES

Management's Responsibilities. The *Government Management Reform Act of 1994* (GMRA) requires each Chief Financial Officer (CFO) Act agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To assist the Department of Transportation in meeting the GMRA reporting requirements, the FAA prepares annual financial statements.

Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparation of the Management's Discussion and Analysis (including the performance measures), the required supplementary information, and required supplementary stewardship information; and
- Complying with laws, regulations, contracts, and grant agreements, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2004 and 2003 financial statements of the FAA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and



- Evaluating the overall financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2004 audit, we considered the FAA's internal control over financial reporting by obtaining an understanding of the FAA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered the FAA's internal control over required supplementary stewardship information by obtaining an understanding of the FAA's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over required supplementary stewardship information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the FAA's fiscal year 2004 financial statements are free of material misstatement, we performed tests of the FAA's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the FAA. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether the FAA's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

DISTRIBUTION

This report is intended for the information and use of FAA's management, the Department of Transportation's Office of Inspector General, OMB, the Government Accountability Office, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 1, 2004

REPORTABLE CONDITIONS

Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FAA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. We consider the following to be reportable conditions.

1. Implementation of a New Financial Accounting System

Background: In November 2003 the FAA began using the Department of Transportation's Delphi financial accounting system, retiring the use of the Departmental Accounting and Financial Information System (DAFIS) legacy system. Delphi, an Oracle-based financial system, now serves as FAA's integrated general and subsidiary ledger. Several feeder and subsidiary systems (e.g., grants, human resources, logistics, labor distribution, cost accounting, procurement, etc.) interface data with Delphi. The consolidated financial statements and important subsidiary detail are provided by Delphi. The implementation of Delphi presented management with many challenges, typically found in the first year of implementation of new systems. Several of those challenges resulted in lapses in control and other system-related deficiencies that required manual workarounds, additional personnel, and management attention during the year in order to produce accurate financial statements. The implementation of Delphi also interfered with FAA's ability to report financial information timely and accurately during the year.

Conditions: We noted the following matters related to the implementation of the new financial management system:

- *Interface errors with feeder and subsidiary systems:* Weaknesses in FAA's development of interfaces between Delphi and existing subsidiary or feeder systems used by FAA, including the cost accounting, procurement, credit card, and budget execution systems, created errors in financial information until software modifications were completed after the implementation of Delphi. For instance, there were over \$55 billion in transaction errors generated due to the interface between Delphi and FAA's procurement system. These errors were not corrected at a detailed level until up to eight months after the transaction occurred. Further, interface errors between Delphi and the cost accounting system led to nine months of transactions, totaling approximately \$9 billion, from being processed by the cost accounting system until eleven months into the fiscal year.
- *Transactions made outside of the accounting system:* Errors in the interface between the procurement and accounting system required certain payments, primarily those made earlier in the year immediately following the implementation of Delphi, to be processed outside the Delphi system and recorded subsequent to the transaction. The FAA recorded approximately \$744 million of payments to vendors outside of Delphi via the Electronic Certification System (ECS) maintained by the Department of Treasury.
- *Failure to process financial transactions timely:* As a result of interface errors and the lack of training, a number of transactions were not recorded into Delphi in a timely manner. For example, the \$744 million of ECS payments described above were not recorded into Delphi until approximately eight months into the fiscal year.

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- *Lack of adequate training prior to system implementation:* Some Delphi system users were inadequately trained prior to the implementation of Delphi. Once trained, some of these individuals demonstrated a lack of understanding of the new accounting structure in Delphi, and of the new business processes put in place to support Delphi. As a result, the FAA retrained over 450 personnel on the proper use of accounting codes in Delphi, and had to reiterate the new business processes to support Delphi.
- *Lack of timely reconciliations:* The FAA did not perform timely reconciliations of subsidiary systems and supporting records to the general ledger balances in Delphi. In some cases reconciliations were not completed timely. For example, of the eight subsidiary ledger reconciliations that should be performed by FAA, we found that three reconciliations had not been completed during fiscal year 2004. Further, FAA did not have effective policies and procedures in place during fiscal year 2004 to utilize automated exception and edit reports in Delphi to identify and resolve questionable or erroneous transactions.

To address the conditions noted above, the FAA implemented extensive compensating processes and manual controls to identify and temporarily correct system deficiencies until more permanent processes could be installed. This process included frequent meetings with the Deputy Administrator and other senior FAA and DOT management officials on the status of corrective actions, the assignment of additional resources to perform analyses, the reviewing and matching of source documents to record correcting entries, putting in place multiple levels of supervisory review of transactions, and the canvassing of field and headquarters personnel on additional issues not yet resolved. FAA's actions, which were supported by management of the Department of Transportation, effectively mitigated the effects of post-conversion issues on the financial statements.

Criteria: The Government Accountability Office's (GAO) *Standards of Internal Control in the Federal Government* (GAO Standards) states that transactions should be recorded completely, accurately and timely. In addition, the GAO Standards require management to identify the knowledge and skills needed for various jobs and establish good human capital practices, to include the timely training of staff. Further, the GAO Standards require that information be recorded and communicated to management and others within the entity in a form and within a timeframe that enables them to carry out their internal control and other responsibilities. For example, program managers need accurate and timely financial information to determine whether they are meeting their agencies' strategic and annual performance plans, and meeting their responsibilities for the effective and efficient use of agency resources.

The Joint Financial Management Improvement Program (JFMIP) publications and OMB Circular No. A-127, *Federal Financial Systems*, outline the requirements for Federal systems. JFMIP's *Core Financial System Requirements* states that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities.

OMB Circular No. A-127 prescribes policies and standards for Federal agencies to follow in developing, operating, evaluating and reporting on financial management systems. In particular, OMB Circular No. A-127 specifies the need for integrated financial systems. OMB Circular No. A-127 also requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Wherever appropriate, data needed by the systems to support financial functions should be entered only once and other parts of the system should be updated through electronic means consistent with the timing requirements of normal business or transaction cycles.

Recommendations: We recommend that the FAA:

- Identify and correct all significant Delphi system and subsidiary ledger interface weaknesses to develop a fully integrated financial management system as required by OMB Circular No. A-127;
- Implement procedures to record transactions in a timely manner;
- Provide appropriate follow-up training to accounting and field staff who have access to Delphi; and
- Complete the corrections to the Delphi accounting records, and ensure transactions are reconciled to the general ledger balances.

FAA Response: FAA has reviewed the reportable condition related to the implementation of Delphi and agrees with KPMG's recommendations. As is typical with any large system implementation, FAA experienced many challenges. However, as KPMG noted, FAA, through a combination of extensive senior level involvement and significant staff effort, addressed those issues aggressively to ensure that financial data was accurate and complete. During fiscal year 2005, we agree to continue our commitment to improve the processes and procedures by performing a complete analysis of our year-end closing process, by continuing our efforts to find and remedy issues that arise from the operation of the system (including the Delphi critical issues resolution process and additional training), performing monthly analysis and reconciliations, and developing new on-going review processes to locate potential problems earlier.

2. Cost Accounting Information

Background: The FAA has reorganized its operations in the past year to align functional and operational units with its missions and goals. One benefit of this reorganization is an ability to improve management accountability through performance and cost reporting. Essential to achieving the goal of improved performance reporting is the effective implementation of FAA's Cost Accounting System (CAS) with the new Delphi general ledger system.

Condition: During fiscal year 2004, the FAA was unable to provide comprehensive internal management cost reports from CAS due primarily to issues related to implementation of a new accounting system. Early in fiscal year 2004, the FAA was unable to extract the necessary data from Delphi in a format needed for input into CAS to allocate costs, enable comparisons of actual costs with goals, and compare costs with outputs and outcomes. Without cost data readily available, the FAA could not produce meaningful internal management cost reports, as required by Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Standards and Concepts*. Lacking this information, FAA managers did not have the required financial reports necessary to make fully informed decisions about the usage of FAA's resources during fiscal year 2004.

Further, CAS is not being used to account for costs in all lines of business within the FAA. The FAA still does not process or report costs through CAS for two lines of business (Regulation and Certification, and Airports), and has not modified CAS to reflect the cost structure of the new Air Traffic Organization (ATO). In addition, the FAA lacks a fully effective labor distribution and tracking system to provide sufficient data to allocate labor costs by program and activity.

Finally, improvements are needed in the system used by air traffic controllers and engineers to track and report time worked by project and task for allocation using CAS. According to a report issued by the Department of Transportation's Office of Inspector General (DOT OIG), the current labor distribution system lacks effective controls over the recording of start and stop times for each work day, allowing controllers and engineers to easily override the system's time stamp mechanism. Also,

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based on the current labor agreement with unionized controllers and engineers, indirect activities, such as paid breaks and union activities, are not currently tracked using the existing labor distribution system.

Criteria: SFFAS No. 1, *Objectives of Federal Financial Reporting*, states that an objective of federal financial reporting is “to provide useful information to assist internal and external users in assessing operating performance.” SFFAS No. 4 requires that “each reporting entity should accumulate and report the costs of its activities on a regular basis for management information purposes.”

Recommendations: We recommend that FAA:

- Develop procedures to accumulate and present cost data consistent with the requirements of SFFAS No. 4 for both internal and external financial reporting;
- Use CAS to process and report costs for all lines of business in the FAA; and
- Improve the accuracy of labor distribution information reported by air traffic controllers and engineers.

FAA Response: FAA has reviewed the reportable condition related to lack of timely cost accounting and agrees with KPMG’s recommendations. FAA recognizes the importance of cost accounting information to the operation of the agency, and plans to provide cost accounting data to those organizations that currently receive data on a monthly basis, beginning in January 2005. We will continue implementation of the cost accounting system for all lines of business in fiscal year 2005 with completion scheduled in fiscal year 2006. FAA will also continue to improve the quality of the cost accounting data and to simplify the cost allocation methods used by the system.

3. Reconciliations of Fund Balance with Treasury

Background: The Fund Balance with Treasury (FBWT) account is an asset representing the future economic benefit of monies that can be spent for authorized transactions. Federal agencies use the FBWT account to reconcile with records from the Department of Treasury’s Financial Management Service. This reconciliation is essential to enhancing internal controls, improving the integrity of financial information in Delphi, and providing more accurate measurement of budget results. An adequate reconciliation provides the assurance that processed transactions are properly and timely recorded in the FAA’s accounting records and financial statements, which then allow management the ability to make decisions about the proper use and accountability of FAA’s resources.

Conditions: We noted the following internal control weaknesses related to FBWT:

- The FAA’s FBWT reconciliations were not adequately performed in a timely fashion for the first nine months of fiscal year 2004. Any differences noted between disbursements and deposits recorded in Delphi and those recorded at the U.S. Department of Treasury were recorded into a suspense account in Delphi with limited follow-up. The FAA cited resource constraints and the lack of timely recording of transactions into Delphi as the primary causes for the weaknesses in the FBWT reconciliation process;
- The FAA did not clear items carried in suspense accounts timely during the year. As of June 2004, the FAA had identified almost 11,600 disbursements, totaling approximately \$439 million, which had been recorded in FAA’s FBWT but not recorded in Delphi. This resulted partly from the use of ECS payments made outside of the normal process of disbursements. From June through September 2004, the FAA dedicated significant resources

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to this issue, and was able to identify and substantially reconcile these unreconciled transactions prior to September 30, 2004; and

- As a separate matter, for those reconciliations that were performed during the last three months of the fiscal year, there were weaknesses in the reconciliation process. The FAA uses three groups to prepare the FBWT reconciliation. FAA personnel were unable to show a clear and consistent link between the three parts of the FBWT reconciliation. As a result, reconciling items on each part of the FBWT reconciliation have the potential to go unresolved due to the lack of communication among the three groups within the FAA that perform the FBWT reconciliation.

Criteria: The Department of Transportation's *Financial Management Policies Manual*, Section 3.04.3–*Reconciliations*, states that each operating administration in the DOT is responsible for reconciling all transactions posted to all clearing accounts monthly. The agency should reclassify all clearing account transactions to the correct Treasury account symbol on the next reporting cycle, but no later than two months after the accomplished date. Further, *GAO Standards* states internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. All documentation and records should be properly managed and maintained.

Recommendations: We recommend that FAA:

- Prepare monthly reconciliations of FBWT, including resolution of differences;
- Implement controls and procedures for clearing suspense accounts in a timely fashion;
- Provide adequate Delphi training to enable FAA personnel to produce all necessary system reports to research these transactions timely;
- Ensure compliance with policies and procedures related to monitoring suspense account activity as documented in the Department of Transportation's *Financial Management Policies Manual* and the *Treasury Financial Manual*; and
- Continue FAA's policy to curtail the use of ECS payments.

FAA Response: FAA has reviewed the reportable condition related to inadequate reconciliations of fund balance with Treasury and agrees with KPMG's recommendations. When FAA first implemented Delphi, FAA focused its resources on paying vendors (use of ECS) and then getting the ECS transactions properly recorded in Delphi after payments were made. Although these actions ensured payments were made, they drew resources from managing suspense accounts and performing regular reconciliations. Now that FAA is in its second year of Delphi use, FAA has drastically reduced its use of ECS. FAA is refocusing its resources on stable, regular processes that support managing its suspense account balance. FAA also recognizes that it needs to improve the reconciliation process for fund balances with Treasury, and consequently, plans a comprehensive review of the process by all parties to ensure that FAA has a coordinated reconciliation process. Implementation of recommendations from the review, combined with increased management review and training for technicians, will substantially strengthen our reconciliation process. This represents just a few of the many steps FAA will take during fiscal year 2005 to implement KPMG's recommendations.

4. Information Technology Controls over FAA and Third-Party Systems and Applications

Background: General controls related to the FAA's primary financial applications owned by either the FAA or the Department of Transportation, including Delphi, need to be improved. Specifically, we noted weaknesses in network information security management and application security controls, including system-level access issues, application-level operational access controls for sensitive and

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critical functions, separation of duties, change management and application controls. FAA's information technology and financial management systems environment include Delphi and a number of subsidiary and feeder systems, including:

- Delphi, the DOT accounting system used by FAA;
- PRISM, the FAA's procurement system;
- Airport Improvement Program system (AIP);
- Electronic Clearing House Operations system (ECHO);
- Cost Accounting System (CAS);
- Integrated Personnel and Payroll System (IPPS);
- Consolidated Uniform Payroll System (CUPS);
- Consolidated Personnel Management Information System (CPMIS); and
- Logistics Information System (LIS).

Conditions: We noted the following information technology (IT) and financial system control and functionality weaknesses at FAA:

- Instances of security program certification and accreditation documentation not updated or in draft form only;
- Instances of weaknesses in user account management practices were noted including inactive and unused accounts highly susceptible to compromise, and system password control parameters over user accounts not set, such as passwords set to never expire and unlimited login attempts allowed. Also, we noted user accounts for most applications were not periodically reviewed for appropriate authorizations to application programs and data and to identify excessive access privileges;
- Instances of key application servers or network devices were not configured in the most secure manner including sensitive system and user account information that could be obtained without user authentication onto the system;
- Instances where the FAA did not always document changes made to applications, including change approvals and testing. Procedures for documenting, approving, and implementing application changes were not consistently in place and applied;
- Instances where individuals were able to perform incompatible functions, such as technical support staff with access to end user operational functions and end users with high risk combination of operational functions susceptible to abuse or misuse without sufficient compensating controls in place; and
- Instances of financial system integrity weaknesses requiring manual reconciliation processes to be established.

Through our substantive testing of transactions processed through these systems, we concluded that FAA management implemented effective oversight and monitoring procedures to ensure that errors were detected and corrected in a timely manner. Although we noted instances in which management did not record correcting entries in a timely fashion at a detail level, we noted that FAA had effective procedures in place to record transactions in Delphi at a summary level in the general ledger.

Criteria: Controls over IT and related financial systems are essential elements of financial reporting integrity. Effective general controls in an IT and financial systems environment are typically defined in six key control areas: entity-wide security program planning and management, access control,

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application software development and change control, system software, segregation of duties, and service continuity. In addition to reliable controls, Federal financial management system functionality is important to program monitoring, increasing accountability of financial and program managers, providing better information for decision-making, and increasing the efficiency and effectiveness of services provided by the Federal government.

OMB Circular No. A-130, *Management of Federal Information Resources*, Appendix III, requires Federal agencies to establish application security plans to assure that adequate security is provided for information collected, processed, transmitted, stored, or disseminated through the system.

National Institute of Standards and Technology Special Publication Number 800-18, *Guide for Developing Security Plans for Information Technology Systems*, states the purpose of security plans are to provide an overview of the security requirements of the system and describe the controls in place or planned for meeting those requirements; and delineate responsibilities and expected behavior of all individuals who access the system.

Recommendations: We recommend that the FAA, in coordination with the DOT:

- For entity-wide security program planning and management over the applications reviewed, maintain up-to-date and complete security program documentation in accordance with the application's appropriate data classification (e.g., mission critical information system).
- For access control:
 - a. Resolve system security issues noted in ECHO, AIP, PRISM, and CAS;
 - b. Identify those individuals who require privileged access to Delphi accounting functions based on "least privileged, need to know" principles. Eliminate those individuals with unnecessary access to Delphi's operating system;
 - c. Monitor appropriateness of user access to the Delphi operating system and Delphi operational functions via audit logging capabilities; and
 - d. Improve the oversight and management of duplicate accounts in IPPS and access authorization to sensitive and incompatible functions.
- For application software development and change control of AIP, PRISM, and CAS:
 - a. Maintain up-to-date and approved change management policies and procedures that requires changes to be authorized and tested prior to implementation;
 - b. Adopt change management policies and procedures on a consistent basis; and
 - c. Adopt policies to require analysis of change requests to ensure consistency with agency policies, user requirements, and implementation schedules.
- For segregation of duties, perform an analysis of IT and end user position responsibilities and implement policies and procedures in ECHO, IPPS, PRISM, and Delphi to improve segregation of duties for IT and accounting functions, including documentation of key security positions.
- For financial system functionality, work to resolve the financial system integrity and functionality issues noted in Delphi.

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Due to the sensitive nature of these issues, we provided the detailed results of our review, along with more specific recommendations, separately to management.

FAA Response: FAA has reviewed the reportable condition related to information technology controls over FAA and third-party systems applications and agrees with KPMG's recommendations. FAA, through the leadership of our Chief Information Officer, is committed to maintaining data integrity and system security. FAA will fully implement all of KPMG's recommendations related to FAA's systems and will work with third parties that operate systems for FAA to ensure the third party complies with KPMG's recommendations. We will also work with DOT toward accomplishing these goals for DOT-sponsored systems.

5. Cost Reimbursable Contracts

Background: The DOT OIG reported in fiscal year 2002 that the FAA was not properly administering cost reimbursable contracts. Specifically, the DOT OIG found that contracting officers exercised little effective oversight and lacked the basic information needed to properly manage, pay, and close contracts. The DOT OIG recommended that the FAA implement the necessary controls over the monitoring of cost reimbursable contracts, and that FAA perform close-out reviews of the \$6 billion backlog of completed, but not yet closed, cost reimbursable contracts. In a follow-up review in June 2004, the DOT OIG found that FAA had obtained \$3 million to fund contract audits, and had requested almost 200 audits of cost reimbursable contracts. FAA had also initiated significant internal control procedures, and had reduced the backlog of completed contracts awaiting audits from \$6 billion to \$1.5 billion.

Conditions: Although FAA has made substantial improvements from fiscal year 2001 in their oversight of cost reimbursable contracts, further improvements are needed. Specifically, we noted:

- Of the \$6 billion backlog reported in fiscal year 2001, the FAA still has a backlog of \$1.5 billion in completed contracts awaiting audits as of September 30, 2004;
- The results of contract audits that have been requested from the U.S. Department of Defense's Defense Contract Audit Agency (DCAA) have not been sufficiently reviewed to improve the close-out process. Once the FAA receives the results from the contract audits, we could not find evidence of any procedures to notify the contracting officers of adverse results that may impact their oversight of other cost reimbursable contracts with those vendors;
- Although FAA has a tracking system in place to monitor the contract audits, we found that FAA should improve their procedures to use the information from these contract audits to adjust their business decisions when entering into other cost reimbursable contracts. Specifically, of the 20 contract audit results that we reviewed, we noted that 3 audit reports from the DCAA reported that the vendors' accounting systems were not adequate to properly administer cost reimbursable contracts. The FAA did not modify its processes in consideration of the weaknesses noted in these vendors' systems; and
- When reviewing the invoices for the cost reimbursable contracts that we sampled, we found no evidence of a detailed review by the contracting officers to detect unallowable costs. This is an important control that FAA should have in place as an initial step in ensuring proper oversight of cost reimbursable contracts.

Criteria: FAA's *Procurement Toolbox Guidance – Contract Administration* provides guidance to management and contracting officers on the procedures that should be followed for proper oversight of cost reimbursable contracts. Further, GAO *Standards* states that monitoring of internal control should include policies and procedures for ensuring that the findings of audits and other reviews are

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promptly resolved. Managers are to (1) promptly evaluate findings from audits and other reviews, including those showing deficiencies and recommendations reported by auditors and others who evaluate agencies' operations; (2) determine proper actions in response to findings and recommendations from audits and reviews; and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention. The resolution process begins when audit or other review results are reported to management, and is completed only after action has been taken that (1) corrects identified deficiencies; (2) produces improvements; or (3) demonstrates the findings and recommendations do not warrant management action.

Recommendations: We recommend that the FAA:

- Resolve the \$1.5 billion backlog of completed contracts awaiting audit;
- Implement effective controls to notify contracting officers of the results of contract audits, and to utilize the information from contract audits when making decisions to award additional cost reimbursable contracts;
- Consider the assessment of vendor systems and procedures to determine the extent of FAA monitoring and follow-up that should be routinely performed; and
- Improve procedures to require a detailed review by contracting officers of invoices for unallowable costs.

FAA Response: FAA has reviewed the reportable condition related to the oversight of cost reimbursable contracts and agrees with KPMG's recommendations. FAA is committed to completing the closeout of the backlog of completed contracts in fiscal year 2005. Furthermore, FAA agrees to modify its policies and procedures to ensure that contracting officers review invoices and contract audit reports to evaluate cost reimbursable contractor performance for the purpose of future awards and to protect the public interest.

COMPLIANCE WITH LAWS AND REGULATIONS

This section discusses one instance of non-compliance with significant laws and regulations.

Federal Financial Management Improvement Act of 1996 (FFMIA)

Background/Criteria: FFMIA requires that an agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.

Condition: The FAA was not in substantial compliance with FFMIA due to the following:

- The FAA uses the DOT's core accounting system, Delphi, to process and record financial transactions. After the implementation of Delphi, the FAA encountered a number of conversion-related challenges that prevented FAA from recording a significant number of transactions in Delphi. This situation then interfered with the FAA's ability to produce accurate and complete financial and budgetary reports. We also noted a deficiency with the application of accounting standards, since FAA has not been able to accurately and timely provide cost data on its programs during fiscal year 2004; and
- Six of the key financial systems used by FAA (ECHO, PRISM, CAS, IPPS, CUPS, and LIS) that feed or support financial data into Delphi do not comply substantially with the categories of FFMIA compliance listed in OMB Circular No. A-127, Section 7 – *Financial Management System Requirements*. Specifically, we noted weaknesses in the following:

Category of Non-Compliance	ECHO	PRISM	CAS	IPPS	CUPS	LIS
Lacks Agency-wide Financial Information Classification Structure				X	X	X
Is not an Integrated Financial Management System			X			X
Does not apply the U.S. Government Standard General Ledger at the Transaction Level				X	X	X
Does not conform to Federal Accounting Standards						X
Lacks Effective Financial Reporting	X					X
Lacks Effective Budget Reporting	X			X	X	X
Inadequate System and Processing Documentation	X					
Does not Adhere to Established Functional Requirements	X			X	X	X
Does not Adhere to <i>Computer Security Act</i> Requirements	X	X	X	X		
Lacks Adequate Internal Controls	X	X	X	X		

Recommendations: We recommend that the FAA:

- Continue to work aggressively toward full integration of its financial management systems and to produce accurate, timely, and reliable management cost reports using the Cost Accounting System; and
- Address and resolve the weaknesses noted in the six key financial systems that do not comply with the categories of FFMIA compliance.

FAA Response: FAA has reviewed KPMG's analysis of FAA's compliance with FFMIA and agrees with KPMG's recommendations. FAA recognizes the importance of complying with Federal financial management systems requirements, applicable Federal accounting standards, and processing transactions in accordance with the U.S. Government Standard General Ledger. FAA will fully implement all of KPMG's recommendations related to FAA's systems and will work with third parties that operate systems for FAA to ensure the third party complies with KPMG's recommendations.

EXHIBIT 3

STATUS OF PRIOR YEAR REPORTABLE CONDITIONS, AND NON-COMPLIANCE WITH SIGNIFICANT LAWS AND REGULATIONS

Prior Year Condition	As Reported At September 30, 2003	Status As Of September 30, 2004
Controls over property, plant and equipment	<u>Reportable condition:</u> The FAA did not fully adhere to its policies and procedures designed to ensure that PP&E is stated in accordance with accounting principles generally accepted in United States of America.	<u>No longer deemed a reportable condition:</u> The FAA implemented procedures to resolve this issue.
Process for estimating environmental liabilities	<u>Reportable condition:</u> The FAA lacks adequate policies and procedures to consistently and accurately determine the estimated environmental liability for financial statement purposes.	<u>No longer deemed a reportable condition:</u> The FAA implemented procedures to resolve this issue.
Information technology controls over FAA and third-party systems and applications	<u>Reportable condition:</u> Certain general controls related to the FAA's primary financial applications owned by the FAA and the DOT need to be strengthened.	<u>Continue as a reportable condition:</u> Although improvements were made, weaknesses still remain in controls over FAA and third-party systems and applications.
Non-compliance with the <i>Federal Financial Management Improvement Act</i>	<u>Non-compliance with laws and regulations:</u> FAA was not in substantial compliance with FFMIA because: (1) DOT's core accounting system, DAFIS, cannot produce auditable financial statements and is not compliant with the U.S. Government Standard General Ledger at the transaction level; (2) security over financial information systems needed to be improved; (3) managerial cost accounting standards were not fully implemented; and (4) the financial management systems are not fully integrated.	<u>Continue reporting as a non-compliance with laws and regulations:</u> Although improvements were made (such as the implementation of Delphi to replace DAFIS), the FAA is still in material non-compliance with FFMIA due to (1) managerial cost accounting standards were not fully implemented; and (2) the financial management systems were not fully integrated.
Non-compliance with the <i>Anti-Deficiency Act</i>	<u>Non-compliance with laws and regulations:</u> The FAA's Chief Counsel's office determined that certain transactions constituted violations of the <i>Anti-Deficiency Act</i> .	<u>No longer deemed a non-compliance issue:</u> No instances of non-compliance with the <i>Anti-Deficiency Act</i> were noted during the fiscal year 2004 audit.